

Date: June 3, 1999.

Summary Conclusion: A federal savings association, pursuant to its commercial lending authority under HOLA § 5(c)(2)(A), may purchase accounts receivable at a discount from merchants with recourse to the merchants if the accounts become delinquent.

Subject: Home Owners' Loan Act/Savings Association Powers.



Office of Thrift Supervision

Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

P-99-5

Chief Counsel

June 3, 1999

[

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Re: Purchase of Accounts Receivable by a Federal Savings Association

Dear []:

This responds to your inquiry to the Office of Thrift Supervision (“OTS”) on behalf of [], (the “Association”), concerning whether the Association may purchase accounts receivable at a discount from merchants with recourse to the merchants if the accounts become delinquent.

In brief, we conclude that the Association may conduct the proposed activity pursuant to its commercial lending authority under section 5(c)(2)(A) of the Home Owners’ Loan Act (“HOLA”).¹

I. Background

The Association proposes to purchase accounts receivable at a discount from various merchants. Under the proposal, the repayment term of the accounts receivable to be purchased may vary from 30 to 90 days. The types of merchants from which the Association will purchase accounts receivable may include, for example, temporary employment agencies and medical offices. The discount will be designed to compensate the Association for relieving the merchant of the administrative burden of invoicing and processing the accounts receivable and for providing the funds to the merchant before the accounts could be collected from the accounts receivable debtors. The amount of the discount, while negotiable, will generally be two to four percent of the face value of the accounts receivable purchased.

¹ 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

The Association does not propose to purchase accounts that are “delinquent,” by which you mean no more than 30 days past the due date on the invoice at the time of purchase. In general, the Association plans to purchase no more than \$[] in accounts receivable from any merchant, and usually will purchase less. The Association anticipates developing a portfolio of accounts receivable after two years of approximately \$[].² You represent that this portfolio, when combined with all other commercial loans the Association makes, will not exceed the percentage of assets limitations in HOLA § 5(c)(2)(A).³

The Association proposes to be responsible for collecting the accounts receivable and contracting with [], a software licensing company (the “Company”), for assistance. The Company will provide the licensed software necessary for carrying out administrative tasks associated with servicing the accounts receivable, as well as management assistance in developing the business and securing new accounts.⁴ In exchange for the software and assistance, the Company will receive a percentage of the discount received by the Association, which will be payable to the Company when the Association purchases accounts from merchants (not as the accounts are collected from debtors).⁵

The Association proposes to take a number of significant steps to minimize the credit risk of the activity. First, the Association will purchase the accounts receivable with recourse. This arrangement will require the merchants selling the accounts receivable to agree to repurchase, at the invoice amount rather than the discounted amount, any account that becomes more than 30 days past due. Second, the Association will require each selling merchant to maintain an account at the Association

² You represent that the portfolio will constitute commercial loans for accounting purposes.

³ HOLA § 5(c)(2)(A) provides that the aggregate amount of secured or unsecured loans for commercial, corporate, business, or agricultural purposes may not exceed 20 percent of the total assets of the federal savings association and that amounts in excess of 10 percent of such total assets may be used only for small business loans.

⁴ [

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⁵ You indicate that the Company’s percentage is still to be negotiated, but may be up to [] percent of the discount for the initial accounts receivable purchased and [] percent of the discount for accounts receivable purchased thereafter.

for setoff in connection with the repurchase of delinquent accounts receivable.⁶ Third, the Association will underwrite its purchases of accounts receivable as though the Association were making loans to the selling merchants, requiring them “to pass credit muster.”⁷

II. Discussion

The purchase of accounts receivable at a discount from merchants with recourse is an activity authorized under HOLA § 5(c)(2)(A), which authorizes federal savings associations to engage in commercial lending. That provision states, in relevant part, that “secured or unsecured loans for commercial, corporate, business, or agricultural purposes” are permitted, subject to a percentage of assets limitation (discussed above in footnote 3). HOLA § 5(c)(6) provides that for purposes of HOLA § 5(c), “[T]he term ‘loans’ includes obligations and extensions or advances of credit; and any reference to a loan or investment includes an interest in such a loan or investment.”⁸

The current language of HOLA § 5(c)(2)(A) was enacted in 1989 as part of section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”).⁹ Prior to FIRREA, the authority of a federal savings association to conduct commercial lending was contained in HOLA § 5(c)(1)(R),¹⁰ a provision promulgated as section 325 of the Garn-St Germain Depository Institutions Act of 1982 (“Garn-St Germain”).¹¹ While FIRREA changed the percentage of assets limitation applicable to commercial lending, it did not change the statutory language authorizing commercial lending.

⁶ You indicate that funds in this account will generally be for an amount equal to ten percent of the outstanding accounts receivable the Association purchases from the particular business entity, but could vary based on the credit risk involved.

⁷ You further indicate that, in most cases, the Association will require personal guarantees from the principals of the business entities, in keeping with the Association’s usual commercial lending practice. Finally, the Association plans to purchase accounts receivable credit and fraud insurance from [] which will cover repurchases if the reserve in the setoff account were insufficient or if a business entity were to defraud the Association. You indicate, however, that the Association might discontinue such coverage if it became unavailable or financially unfeasible.

⁸ 12 U.S.C.A. § 1464(c)(6) (West Supp. 1999).

⁹ Pub. L. 101-73 § 301 (1989).

¹⁰ 12 U.S.C.A. § 1464(c)(1)(R) (West 1989).

¹¹ Pub. L. 97-320 § 325 (1982).

In implementing Garn-St Germain, the Federal Home Loan Bank Board, OTS's predecessor, described the scope of the commercial lending authority granted to federal savings associations as follows in the preamble to a 1983 final rule:

Commercial loans made pursuant to the new authority may take the form of loan transactions in which funds are advanced in exchange for a term note or under a revolving credit agreement, or may take less conventional forms. For example, commercial credit may be extended through a purchase of a business'[s] accounts receivable ("factoring"); through a reverse repurchase agreement with a corporate entity; through a "deposit" with a financial institution; through the acceptance of a customer's time draft; or through the purchase of debt obligations of a business entity.¹²

This preamble text indicates that the purchase of a business's accounts receivable, a practice known as "factoring," is permissible for federal savings associations under the commercial lending authority.¹³ We note that your proposal is to purchase accounts receivable with recourse and that the preamble does not address whether permitted purchases of accounts receivable are to be limited to non-recourse transactions. We do not read the preamble to impose such a limitation and we find no reason to construe the commercial lending authority of federal savings associations in such a restricted manner. By purchasing accounts receivable with recourse, the Association will bear less risk than it would by purchasing accounts receivable without recourse.¹⁴

In 1996, OTS streamlined its Lending and Investment rule.¹⁵ Although OTS deleted regulatory language "which simply reiterated the HOLA's grant of authority to

¹² Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23,032, 23,045 (May 23, 1983) (emphasis added).

¹³ Some authorities regard "factoring" as the purchase of accounts receivable without recourse. See, e.g., John Downes and Jordan Goodman, Dictionary of Finance and Investment Terms 122 (2d ed. 1987); Lewis E. Davids, Dictionary of Banking and Finance 93 (1978). Other authorities, however, indicate that "factoring" may also be with recourse. See, e.g., Jan R. Williams, GAAP Guide: Restatement and Analysis of Current FASB Standards, 9.11 (1999). Yet other authorities give no indication either way. See, e.g., Dennie E. Logue, Handbook of Modern Finance, 44-38 (2d ed. 1990).

¹⁴ We note that factoring without recourse is an activity authorized for national banks. Office of the Comptroller of the Currency ("OCC") Interpretive Letter No. 712 (Feb. 29, 1996). See also OCC regulations 12 C.F.R. § 7.1020 (1999) ("Purchase of open accounts"); Interpretive Rulings, 61 Fed. Reg. 4849, 4854 (February 9, 1996) (explaining that § 7.1020 "relates to a national bank's ability to engage in factoring").

¹⁵ Lending and Investment, 61 Fed. Reg. 50,951 (September 30, 1996).

federal thrifts to invest in and make commercial loans not to exceed 10 percent of their assets,” it incorporated the commercial lending authority and statutory limitation into a new lending and investment powers chart.¹⁶ This regulatory change did not reduce the flexibility of federal savings associations to perform commercial lending, including purchasing accounts receivable.¹⁷

The conclusion that the proposed activity is authorized under the commercial lending authority also flows logically from the HOLA. The credit judgments and risks involved in purchasing accounts receivable are similar to those in making commercial loans using accounts receivable as collateral, another activity authorized for federal savings associations.¹⁸ In purchasing accounts receivable there is a risk that the accounts will not perform. Similarly, in making commercial loans secured by accounts receivable, there is a credit risk of default. Purchasing accounts receivable is simply an alternative way for the Association to take on credit risk in the commercial lending context.¹⁹ Here, the Association has proposed to structure its purchases of accounts receivable in a manner that minimizes the credit risk to the Association by, among other steps, requiring recourse, establishing a setoff account, and applying loan underwriting standards.

The Association must implement appropriate policies, procedures, controls, and oversight mechanisms to ensure that it conducts the proposed activity in a safe and sound manner. The Association also must comply with all applicable commercial

¹⁶ See 61 Fed. Reg. at 50,957 (explaining change) and 50,971-74 (removing § 545.45 and promulgating § 560.30).

¹⁷ In fact, OTS explained that under the revised rule “federal thrifts will be afforded modest additional flexibility to expand their commercial lending” because OTS removed the requirement that commercial loans made at the service corporation level be aggregated with the 10 percent of assets limitation on commercial lending. 61 Fed. Reg. at 50,957-58.

¹⁸ See OTS Thrift Activities Regulatory Handbook § 214, “Other Commercial Lending, Accounts Receivable Financing” (January 1994).

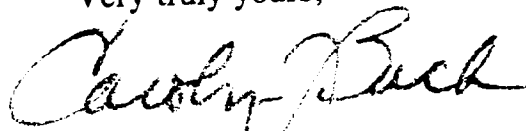
¹⁹ Cf. OTS Op. Chief Counsel (March 11, 1999) at 6 (OTS indicated, as part of the rationale for concluding that a federal savings association may participate in a reciprocal mortgage guaranty reinsurance program thereby taking back risk on its own mortgage loans, that the credit judgments and risks are similar to those in making residential real property loans); OTS Op. Chief Counsel (October 2, 1998) at 3-4 (in concluding that a federal savings association may take back risk on its low down payment mortgage loans by issuing performance guaranties, OTS indicated that the credit judgments and risks are similar to those in making residential mortgage loans); OTS Op. Chief Counsel (January 10, 1995) at 5 (in concluding that a federal savings association operating subsidiary may underwrite and reinsure credit insurance on its mortgage and consumer loans, OTS indicated that such activities are an alternative way to deal with the credit risk that a borrower may become unable to meet the repayment obligation).

lending requirements such as limitations on the percentage of assets and loans to one borrower,²⁰ as well as any documentation requirements the Region may impose.

In reaching the conclusions set forth herein, we have relied on the factual information and representations contained in the materials you submitted to us and in a telephone conversation with OTS staff. Our conclusions depend upon the accuracy and completeness of such information and representations. Any material differences in the facts or circumstances submitted to us and described herein could result in different conclusions.

We trust that this is responsive to your inquiry. Please feel free to contact Richard Bennett, Counsel (Banking and Finance), at (202) 906-7409, if you have any questions concerning this matter.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Carolyn J. Buck".

Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel

²⁰ See OTS regulations 12 C.F.R. §§ 560.30 and 560.93 (1999). Purchases of accounts receivable with recourse are considered to be loans or extensions of credit for purposes of loans to one borrower limitations. See 12 C.F.R. § 32.2(j)(1)(iv) (1999).